Perspectives

A Quarterly Newsletter for Clients of Parsons Capital Management

Quarter 4, 2018

by John Mullen and Ruth Mullen

As the fourth quarter opened, despite the turmoil roiling international markets, domestic stocks were enjoying healthy gains and seemed on their way to a tenth straight positive year. In the next three months, we witnessed a quarterly decline worse than any seen since the depths of the Great Recession; it wiped out gains and turned annual returns decidedly negative. Money streamed out of equities and into cash and bonds, causing waterfall declines due to an imbalance of buyers and sellers. Growth stocks, which had handily and persistently outpaced their value peers, were hit particularly hard in the quarter. The risk off tone pervaded further down the capitalization scale, with small cap stocks posting a quarterly decline of over 20%. International stocks continued to pile on their losses from earlier in the year. Emerging markets were hammered by falling commodity prices and the higher US dollar. Developed international was confronted by slowing growth and the continued economic and political uncertainty throughout Europe.

Data as of December 31, 2018	Dec. '18	Qtr. 4 '18	YTD '18
S&P 500	-9.03%	-13.52%	-4.38%
MSCI AC World Index (incl. US)	-7.00%	-12.65%	-8.93%
MSCI EAFE (Europe, Asia, Far East)	-4.83%	-12.50%	-13.36%
MSCI EM (Emerging Markets)	-2.60%	-7.40%	-14.25%
Russell Large cap	-9.11%	-13.82%	-4.78%
Russell Large cap Growth	-8.60%	-15.89%	-1.52%
Russell Large cap Value	-9.60%	-11.73%	-8.27%
Russell Midcap	-9.92%	-15.38%	-9.06%
Russell Small cap	-11.88%	-20.20%	-11.01%

Data compiled from Tamarac Inc.

Fixed Income Markets

The risk off tone seen in equities spilled over into fixed income markets in a flight to safety. The Bloomberg Barclays US Treasury index had a positive return of +2.6% in the quarter. Strength was particularly apparent in the long end, with the 20+ year index up +4.2%. Municipal bonds were also positive standouts, up +1.7% in the quarter. Annual returns for these three sectors of the bond market were 0.9%, -2.0% and 1.3% respectively. High yield was the worst performing fixed income market as concerns over slowing growth and higher borrowing costs pushed the issues down -4.7% in the quarter to end the year down -2.3%. Investment grade corporate credit held up relatively better, returning a negative -0.2% in the quarter and posting an annual return of -2.5%. Internationally, yields in developed markets declined and values went up, resulting in a positive return of +1.8% for the quarter and -0.8 for the year. Emerging market issues suffered a total return decline of -1.2% for the quarter and 4.3% for the year, expressed in US dollar terms.

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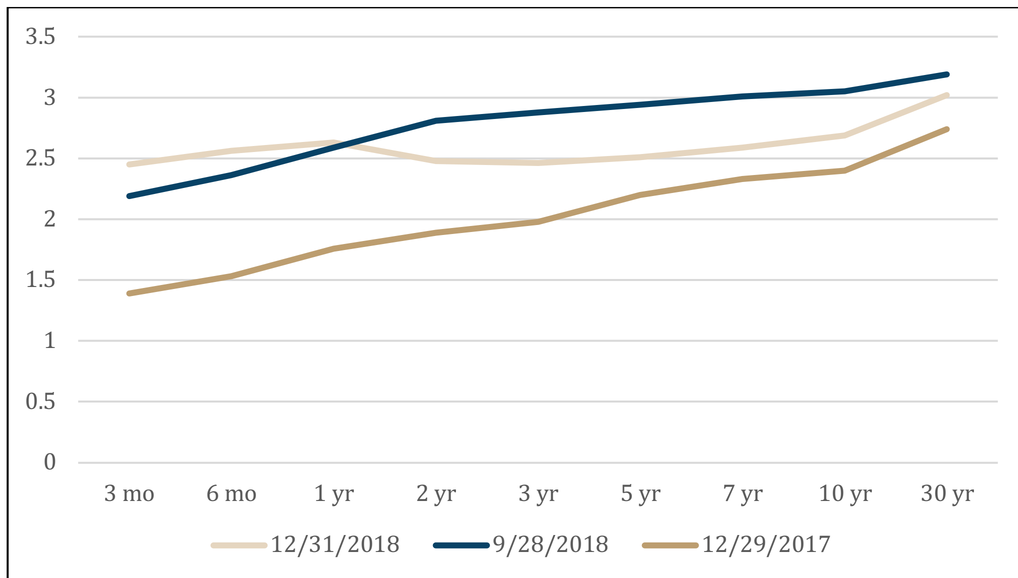
US Treasury Yields

Curve telling the Fed to pause…

Curve inverts, not yet signaling danger…

The yield curve took on a uniquely odd shape by the end of 2019, with the short end of the curve higher than rates in the belly. The effect of the Federal Reserve's rate hike program (both announced and expected) were evident in the move higher in the three month, six month and one year rates when compared to last year and last quarter. At the same time, a declining inflation and growth outlook pulled rates down in the 2 to 30 year range. While the yield curve ended the year with that internal inversion, the part of the curve most often associated with forecasting recession, 10 year minus 2 year, was still positive – i.e. not pointing to recession.



Commodities

Ugly quarter for energy, agricultural holds up…

While it was a poor quarter for commodities, as evidenced by the over 12% decline in the CRB Index, the weakness was most pronounced in the energy segment.

The unexpected granting of waivers by the US government to buyers of Iranian crude left the oil market over-supplied. A production cut by OPEC was not enough to stem the losses, as oil ended the year at $45.44 after peaking over $77 earlier in the year. In sympathy with the move in oil, gasoline futures fell -34% in the quarter and ended the year -6%.

It wasn't all negative for commodities in the final quarter of 2018. Corn and soybeans saw their prices rise on the potential for a trade breakthrough with China resulting in higher demand for the crops.

Commodity	Qtr. 4 '18	Year to Date '18
CRB (Commodity Research Bureau) Index	-12.46%	-10.66%
Oil (West Texas Intermediate)	-37.89%	-24.84%
Gold	7.28%	-2.14%

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Economic Overview

US economy begins to recouple, softens…

Throughout the first three quarters of the year, the domestic economy had been able to shake off the weakness gripping most other countries. By nearly any measure, the US economy remains the envy of the rest of the world, but cracks did begin to appear late in the quarter.

On the positive front:

Job market roaring, inflation tame…

- December payrolls expanded a blistering 312,000 and the prior 2 months were revised higher by 58,000
- In that same report, average hourly earnings grew 3.2% and the unemployment rate moved higher to 3.9% thanks to people reentering the labor market
- Inflation continued to moderate on the back of energy prices and surveys pointing to slowing rent inflation for 2019
- Auto sales ended the year at their highest level since November of '17 when sales had been helped by a hurricane related replacement cycle

Manufacturing and housing were notable weak spots:

Manufacturing, housing relative laggards…

- The manufacturing PMI (Purchasing Managers Index) fell unexpectedly to 53.8 in December from 55.3 in November, although still in expansion mode
- The NFIB (National Federation of Independent Business) survey focusing on small businesses in the US slipped for the fourth straight month
- Higher mortgage rates hit housing sales which were down -2.3% through the first 11 months of the year

Consumer getting healthier, driving retail sales…

The US consumer remained the backbone of the domestic economy and continues to deliver. The savings rate is at a healthy 6% while household net worth, even though dented by the recent market selloff, was still near an all-time high. Lower inflation and a strong jobs market further support consumer sentiment and spending power, not to mention the anticipated $70 billion in refunds expected for taxpayers in 2019 due to tax reform. The minimum wage is set to increase January 1 in 23 states. GDP growth for all of 2018 should come in over 3% and while a repeat of that in 2019 is unlikely, growth should remain solid, especially if manufacturing stabilizes.

While the economic picture in the US did weaken somewhat in the quarter, it still outpaces the rest of the world. The Euro area saw a further softening of activity with the PMI there dropping from 51.8 in November to 51.4 in December. France and Italy stood out as being the two Euro area countries with PMI's below 50, a number that indicates contraction. Supporting the notion of slower growth for the region was the decline in German industrial production for the month of November.

International economies dealing with multiple headwinds…

Emerging markets ended the year even more precariously, with weakness in China having a cascading effect. The PMI average for all emerging economies fell half a point in December to end the year at 50.3. Many of the bellwether countries (China, Korea, Taiwan, Mexico) saw PMI's firmly in contraction territory. China witnessed a contraction in their factory sector for the first time in a year and a half.

Contributing to glimmers of a slowdown in domestic and international growth were concerns about the direction and tenor of trade talks with allies and other trading partners, particularly China. Even as economic activity continued broadly to expand, the increasing drumbeat of warnings and caution from CEO's, economists, and various pundits regarding future trade, revenues and earnings cast a pall on sentiment and introduced the possibility of recession becoming a self-fulfilling prophecy.

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Investment Implications

Virtuous cycle led to ever higher P/Es…

A hallmark of the long bull market which began in 2009 was the expansion of the Price/Earnings ratio (P/E). Optimism about current and future conditions drives P/E ratios higher, and pessimism contracts them. Until late in 2018, company earnings grew and optimism grew even more, fueling the powerful rally especially in the last three years. Monetary conditions were supportive and fiscal policy turned market friendly in 2016. In 2018, monetary policy began to tighten, not just domestically but in other parts of the world. The first wave of stimulus from fiscal policy was incorporated. Questions began to emerge about leadership and direction among those in charge of making fiscal, monetary and trade policy. Volatility, dormant throughout the market advance in 2017, was reborn from uncertainty.

Uncertainty/volatility dents P/E multiples to end the year…

Markets hate uncertainty, and there is plenty of it today. A new Federal Reserve Chair is finding his way in managing and communicating policy, and missteps have been met with violent reactions. Inconsistent rhetoric from the executive branch is confusing and undermines confidence in leadership. All of this heightens the risk of policy missteps in investors' minds, therefore heightening the risk in markets and contracting the P/E even as earnings continue to march higher.

In fact, the forward P/E market multiple declined 15% just during the fourth quarter, culminating in a down market during a year when earnings are expected to advance by at least 20%. The weight of trade and rate uncertainty reached a crescendo after Fed Chair Powell had a disastrous news conference on December 19, in which he seemed aloof to developing concerns over policy and out of touch with what was happening in real time. Then, tough talk of intransigence from the President on trade and the government shutdown further spooked the markets.

Fed outlook, trade uncertainty weigh…

The fourth quarter decline left the forward P/E level well below the 20 year average; the market could rise 10% from current levels and just get back to the historical average. Clarity on the rate outlook and softening of administrative rhetoric in the closing days of 2018 have sparked a rebound in the market from those deeply oversold condition. Can that continue?

Fed rate hike cycle historically good for markets…

The spectre of continued Fed tightening is often raised as a reason markets could continue to decline. The fact is that historically, markets tend to go up during Fed tightening cycles and roll over when they have stopped. The logic is that the Fed is tightening because the underlying economy is strong enough to withstand it and inflation may be building (the former is true today; the latter is not). The Fed is attempting to get rates up in an orderly fashion from the abnormally low level which was deemed necessary to bring the economy out of the Great Recession to a "normal" range in order to have that monetary tool to mitigate the next recession. Given the still resilient economy, the strength of the consumer, the oversold conditions of the year end 2018 market, and where we appear to be in the monetary and business cycles, we think the evidence supports a greater probability of higher returns before the end of this bull market. Policy mistakes could still derail us, which is why vigilance will be key.

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